STATEMENT OF

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on

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Chairman Bachus, Representative Waters, and members of the Subcommittee, it is a great pleasure to appear before you this morning, my first appearance before Congress as Chairman of the Federal Deposit Insurance Corporation, to discuss deposit insurance reform.

Deposit insurance has served this country well for nearly 70 years and helped us through a difficult crisis just over a decade ago. The FDIC has played a key role in maintaining public confidence in our financial sector through good times and bad. The system is not in need of a radical overhaul.

Yet, I agree with the FDIC's analysis that there are flaws in the current system that could actually prolong an economic downturn, rather than promote the conditions necessary for recovery. The current system also is unfair in some ways and it distorts incentives in ways that exacerbate the moral hazard problem. These flaws can be corrected only by legislation. I appreciate the interest this Subcommittee has already shown in considering these issues and the interest you have shown in deposit insurance reform.

In the seven weeks I have been at the FDIC, I have been impressed by the dedication and caliber of the FDIC staff. The staff has prepared an excellent report on deposit insurance reform with very important recommendations. I have studied the report and have full confidence in the product the FDIC has produced. The recommendations, and the way the agency went about coming up with them, are a model for how agencies should create public policy proposals. Staff did its homework and kept all of the players—Congress, the banking industry, scholars and experts, and the public—involved every step of the way. I am proud of our team and what they have put together.

This morning I will take what the FDIC has already recommended and give you my thoughts, as well, on how the Congress can create a better system. First let me discuss the principles that I used in evaluating the FDIC's proposals and the principles that I am bringing to this debate. The new system should be fair, simple, and transparent. Bankers and other interested parties should participate in the process of developing and implementing any reforms to ensure that policy trade-offs are weighed appropriately and the resulting reforms will be reasonable, workable and effective. As I noted earlier, the existing deposit insurance system has served us well, and we must be mindful of this in contemplating changes. The current system is designed to ensure that the deposit insurance funds' reserves are adequate, and that the deposit insurance program is operated in a manner that is fiscally and economically responsible. Any new system should retain these essential characteristics. There are good reasons for most of the features built into our current system, and we must not lose sight of this as we attempt to make improvements.

I believe what the FDIC has recommended is true to these principles, but let me add my thoughts on each of the recommendations.

Merge the BIF and the SAIF

First, we should merge the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). There is a strong consensus on this point within the industry. In fact, I have heard no one, inside the industry or out, suggest otherwise.

Originally, the two funds were intended to insure bank and savings association deposits separately. But today, both funds insure deposits at both types of institutions. Moreover, many institutions currently hold both BIF- and SAIF-insured deposits. More than 40 percent of SAIF-insured deposits now are held by commercial banks. The concept of separate bank and thrift funds is an anachronism.

A merged fund would be stronger and better diversified than either fund standing alone. In addition, a merged fund would eliminate the possibility of a premium disparity between the BIF and the SAIF. As long as there are two deposit insurance funds, the assessment rates of which are determined independently, the prospect of a premium differential exists. A merged fund would have a single assessment rate schedule. Those rates would be set on the basis of the risks that institutions pose to the single fund. The prospect of different prices for identical deposit insurance coverage would be eliminated.

Finally, merging the funds would also eliminate the costs to insured institutions associated with tracking their BIF and SAIF deposits separately, as well as the complications such tracking introduces for mergers and acquisitions.

For all of these reasons, the FDIC has advocated merging the BIF and the SAIF for a number of years, and I wholeheartedly agree. Any reform plan should include fund merger.

Deposit Insurance Coverage

Another issue that has drawn attention is the question of coverage. The task for us is to balance the public's needs for protection, the funding needs of small banks, and the effect of coverage increases on our deposit insurance fund and on the market-distorting moral hazard problem.

I am acutely sensitive to the funding pressures faced by many community banks. This is a complex issue, and there are many factors at work. It is not clear whether a higher coverage limit would significantly ease current funding pressures for most of these institutions.

We must also acknowledge that the impact of raising the coverage limit on the fund reserve ratio is uncertain. The FDIC and others have provided estimates, but it is hard to anticipate the public's reaction to higher coverage limits, and this reaction will determine the ultimate inflow of new deposits into the system. There is also a chance that higher coverage limits could make it easier for riskier institutions to gather deposits, and we must consider the potential for unintended consequences.

I do not believe it necessary to have an across-the-board increase in the basic coverage limit now. We should, however, ensure the present limit keeps its value in the future. For this reason, the deposit insurance coverage level should be indexed to maintain its real value. As a life-long banker, I can tell you that deposit insurance is important not only to individuals and families, but also to many small businesses, community banks, charities, and some local governments. Protecting such an important program from the effects of inflation strikes me as plain common sense.

My suggestion would be to index the $100,000 limit to the Consumer Price Index, and adjust it every five years. The first adjustment would be on January 1, 2005. We should make adjustments in round numbers – say, increments of $10,000 or so – and the coverage limit should not decline if the price level falls. These seem like the right elements of an indexing system, but I am willing to support any reasonable method of indexation that ensures the public understands that the FDIC's deposit insurance protection will not wither away over time. I look forward to working with the Congress to find a method of indexing that works.

There has been some opposition to the FDIC's indexing proposal on the grounds that it would increase the federal safety net. Frankly, I am puzzled by this. The FDIC is not recommending that the safety net be increased. It is simply recommending that the safety net not be scaled back inadvertently because of inflation.

There is one class of deposits for which Congress should consider raising the insurance limit, and that is IRA and Keogh accounts. Such accounts are uniquely important and protecting them is consistent with existing government policies that encourage long-term saving. When we think about saving for retirement in this day and age, $100,000 is not a lot of money. Middle-income families routinely save well in excess of this amount.

Moreover, especially during this time of uncertainty when Americans may be concerned about the safety of their savings, I believe it is important for the United States government to offer ample protection to facilitate saving through vehicles that will redeploy funds into the economy. In my view, we must do whatever we can to provide for ongoing productive investment in our economy and solid, sustainable growth. Higher deposit insurance protection for long-term savings accounts could help.

There is some precedent for providing such accounts with special insurance treatment. In 1978, Congress raised coverage for IRAs and Keoghs to $100,000, while leaving basic coverage for other deposits at $40,000.

The $220 billion of IRA and Keogh deposits currently at banks and thrifts is not large compared to the volume of overall deposits. Thus, if the coverage limit were raised for IRA and Keogh deposits, the initial impact on the fund reserve ratio would not be dramatic. However, the total volume of IRAs and Keoghs in the economy, more than $2.5 trillion, is enormous, and estimating the influx of retirement account deposits as a result of higher coverage is subject to some of the same uncertainties that apply to deposits in general. The FDIC is prepared to investigate the implications of higher coverage for these accounts and provide this information to the Congress and the public. We would also note that a phasing–in of higher coverage limits for retirement account deposits could allow for some measure of control over the impact on the fund reserve ratio. I urge the Congress to give serious consideration to raising the insurance limit on retirement accounts.

Fund Management

When it comes to managing the fund over time, I believe several principles are important. We should be fair and equitable to the industry and to taxpayers. The FDIC should be transparent in its decision making. Deposit insurance should be priced based on risk. Finally, the FDIC Board of Directors must have the flexibility to manage the fund size in periods of stability as well as periods of crisis.

Specifically, the FDIC should have the discretion to set the target size for the fund ratio, determine the speed of adjustment toward the target and charge appropriately for risk at all times. Right now, there are two statutorily mandated methods for managing fund size. One of these methods prevents the FDIC from charging appropriately for risk during good economic times. The other can put undue pressure on the industry during an economic downturn. Together, they lead to volatile premiums.

Under current law, when a fund's reserve ratio is at or above the 1.25 percent designated reserve ratio (DRR), the FDIC is prohibited from charging premiums to institutions that are both well-capitalized, as defined by regulation, and well-rated (generally defined as those with the two best examination ratings). Under this statutory provision, there can be long periods during which the risk-based system is less than fully effective and new deposits enter without paying.

On the other hand, when a deposit insurance fund's reserve ratio falls below the DRR, the FDIC must raise premiums by an amount sufficient to bring the reserve ratio back to the DRR within one year, or charge at least 23 basis points until the reserve ratio meets the DRR. Thus, if a fund's reserve ratio falls slightly below the DRR, premiums need not necessarily increase much. On the other hand, if a fund's reserve ratio falls sufficiently below the DRR, premiums will increase to 23 basis points, at a minimum. The potential for a 23-basis point "cliff effect" is problematic because, during a period of heightened insurance losses, both the economy and depository institutions in general are more likely to be distressed. A 23-basis point premium at such a point in the business cycle would be a significant drain on the net income of depository institutions, thereby impeding credit availability and economic recovery.

These problems can be solved by eliminating the existing inflexible statutory requirements and by giving the FDIC Board of Directors the discretion to set appropriate targets for the fund ratio, determine the speed of adjustment toward the target using surcharges or assessment credits as necessary, and charge premiums based on risk throughout the cycle.

What is the appropriate target for the size of the fund? This will depend upon economic and banking conditions and the other factors that affect the risk exposure of the industry. The target should reflect the best risk analysis based on the most current information, and no one is better equipped to provide this than the FDIC. We are in the best position to gather information about risks in the industry and to analyze it for these purposes using state-of-the-art risk measurement methods.

Likewise, the appropriate speed of adjustment to the target – the proper level of surcharges or assessment credits – will vary with economic conditions and the other factors that influence the industry's condition and outlook.

Although I believe that greater discretion for the FDIC Board of Directors is essential in these areas, I am not suggesting that the current target of 1.25 percent is inappropriate or that there should be no guidelines for the FDIC in managing the size of the fund. On the contrary, I believe the 1.25 percent target has served us well in recent years and is a responsible reserve against the current risks in the banking sector. The current target is a reasonable starting point for the new system.

Moreover, while I would steer clear of automatic triggers or hard targets, I would be happy to work with the Congress to develop some guiding principles for the FDIC Board of Directors in managing the growth or shrinkage of the fund. For example, current law requires the FDIC to publish a schedule for recapitalizing the fund whenever the ratio falls significantly below target; this seems like a reasonable feature to retain in the new system. Finally, in asking for greater FDIC discretion, I recognize the need for accountability. I believe that the FDIC should report to the Congress regularly on its actions to manage the fund, and we are fully prepared to do that.

Pricing Deposit Insurance

How would premiums work if the FDIC could set them according to the risks in the institutions we insure? First, and foremost, the FDIC would attempt to make them fair and understandable. We would strive to make the pricing mechanism simple, straightforward and easy for banks to understand. In my view, we can accomplish our goals on risk-based premiums with relatively minor adjustments to the FDIC's current assessment system.

Insurers—like bankers—generally price their product to reflect their risk of loss. It is important to note that there are significant and identifiable differences in risk exposure among the 92 percent of insured institutions in the FDIC's best-rated premium category. To take just one example, since the mid 1980s, institutions rated CAMELS 2 have failed at more than two-and-one-half times the rate of those rated CAMELS 1. And no institution represents zero risk. An FDIC study of the last banking crisis found that, of the 1,617 bank failures between 1980 and 1994, 565, or 34 percent, were rated CAMELS 1 or 2 two years before failure. Of the 30 bank and thrift failures since 1995, 10, or 33 percent, were rated CAMELS 1 or 2 two years prior to failure. It is clear that all institutions pose some risk to the deposit insurance funds and, therefore, all should pay some risk-based premium.

I am aware of the concern about using subjective indicators to determine bank premiums. We will be sensitive to that issue. Using the current system as a starting point, I believe that the FDIC should consider additional objective financial indicators, based upon the kinds of information that banks and thrifts already report, to distinguish and price for risk more accurately within the existing least-risky (1A) category. The sample “scorecard” included in the FDIC’s April 2001 report represents the right kind of approach. In this example, banks currently in the best-rated category were divided into three groups using six financial ratios in addition to capital and CAMELS ratings (net income, nonperforming loans, other real estate owned, non-core funding, liquid assets, and growth). Actuarial analysis showed that premiums for these three groups, based on the FDIC’s loss experience since 1984, should be on the order of 1, 3 and 6 basis points, respectively; however, we are willing to listen to the industry and Congress regarding alternative pricing schedules that also may be analytically sound. The report also indicated that for the largest banks and thrifts, it might be possible to augment such financial ratios with other information, including market-based data, so long as the final result is fair and does not discriminate in favor of or against banks merely because they happen to be large or small.

In short, I believe the right approach is to use the FDIC’s historical experience with bank failures and with the losses caused by banks that have differing characteristics to create sound and defensible distinctions. We will not follow the results of our statistical analysis blindly—we recognize the need for sound judgment in designing the premium system. For example, the FDIC will not set premiums for the most risky banks and thrifts so high that the premiums themselves will cause failures. Any system we adopt will be transparent and open. The industry and the public at large will have the opportunity to weigh in on any changes we propose through the notice-and-comment rulemaking process.

Essentially, the FDIC wants to be able to fulfill the original mandate Congress gave it in 1991 to design and establish a truly risk-based system that allows the insurer to respond to emerging risks and evolving risk factors.

Assessment Credits

One goal of deposit insurance reform should be that, over time, it produces a better and fairer system without increasing the net costs of deposit insurance for the industry or increasing the risk posed to taxpayers. If the FDIC is charging risk-based premiums to all institutions, then, to check the growth of the fund in good economic times, the FDIC must be able to grant assessment credits.

In its recommendations, the FDIC suggested giving rebates when the fund exceeds a target level or range. I am reluctant to mandate a cash payment out of the fund at this time, given the uncertain economic environment. But we can achieve the desired result by giving banks a credit toward future assessments. Initially, these credits should be allocated in proportion to assessments paid in the past.

Assessment credits based upon past contributions would avoid the moral hazard problems created by tying credits to the current assessment base. Also, assessment credits based upon past contributions would be fair to the institutions that built the insurance funds to where they stand today.

I think a reasonable way to allocate the initial assessment credit would be according to a snapshot of institutions' relative deposit bases at the end of 1996, when both funds had been capitalized. Each institution would get a share of the total amount to be rebated to the industry based on its share of the assessment base at yearend 1996. For example, an institution that held one percent of the industry assessment base in 1996 would get one percent of the industry's total assessment credit. Relative shares of the 1996 assessment base represent a reasonable proxy for relative contributions to fund capitalization, while avoiding the considerable complications that can be introduced by reconstructing the individual payment histories of all institutions.

Assuming that current conditions persist, the initial assessment credit should be sufficient to ensure that the typical bank currently in the best-rated (1A) category could offset its premiums for the next several years.

One of the side effects of the FDIC's current inability to price risk appropriately is that the deposit insurance system today is almost entirely financed by institutions that paid premiums prior to 1997. There are currently more than 900 newly chartered institutions, with more than $60 billion in insured deposits, that have never paid premiums for the deposit insurance they receive. In addition, deposit insurance that is under-priced allows institutions to grow rapidly without paying more for deposit insurance.

Since they are not paying premiums, new institutions and fast-growing institutions are benefiting at the expense of their older and slower-growing competitors. Under the present system, rapid deposit growth lowers a fund's reserve ratio and increases the probability that additional failures will push a fund's reserve ratio below the DRR, resulting in an immediate increase in premiums for all institutions. The FDIC's recommendation to eliminate the 23-basis point "cliff effect" would mean that new deposit growth among a minority of institutions would no longer trigger large premium increases for all others.

The combination of risk-based premiums and assessment credits tied to past contributions to the fund would help us fix the remaining problems related to rapid growers and new entrants. Regular risk-based premiums for all institutions would mean that fast-growing institutions would pay increasingly larger premiums as they gather deposits. Fast growth, if it posed greater risk, also could result in additional premiums through the operation of the FDIC's expanded discretion to price risk. The assessment credits granted to newer institutions and fast growers would be proportionally smaller than those granted to past contributors, and institutions that never paid premiums would initially receive no assessment credits at all.

I understand the industry's concern that the fund—even under the scenarios I have outlined—could grow unnecessarily large. I do not want to unnecessarily accumulate money at the FDIC when it could be put to better use in the economy.

As I mentioned earlier, I believe the FDIC's Board of Directors should be given the flexibility to manage the insurance fund, whether the fund has grown too large or too small. In a crisis, the Board must levy surcharges to ensure solvency. If the fund is too large, the Board must likewise provide more aggressive assessment credits or, at some point, fair and equitable cash dividends. Such credits or dividends would be based on the contributions of each insured institution under the new system.

I take very seriously the responsibility of prudently managing the fund and maintaining adequate reserves—it is extremely important to the industry and to the financial stability of our country. We have only to look back at the bank and thrift crises of the 1980s and 1990s to understand this. While I am Chairman, I will do all I can to ensure that the FDIC manages the insurance fund responsibly and is properly accountable to the Congress, the public and the industry.

CONCLUSION

The Congress has an excellent opportunity to remedy flaws in the deposit insurance system before those flaws cause actual damage either to the banking industry or our economy as a whole. Both insurance funds are strong and, despite a slowing economy, the banking industry also remains very strong. The FDIC has put forward some important recommendations for improving our deposit insurance system. While I believe we should remain flexible with regard to implementation, as a former banker and, as the FDIC's new Chairman, I believe that we should work together to make these reform proposals a reality.